# Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819

CANADIAN RIVER GAS COMPANY,

*Petitioner,*

*against*

JOSEPH T. HIGGINS, FORMERLY UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE THIRD DISTRICT OF NEW YORK,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT OF PETITION.

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## PETITION FOR WRIT OF CERTIORARI.

TO THE HONORABLE THE CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The above named petitioner prays that a Writ of Certiorari be issued to the United States Circuit Court of Appeals for the Second Circuit to review a judgment of that Court rendered in the above case on November 9, 1945 (R. 102) affirming a decision of the United States District Court for the Southern District of New York which had held that the petitioner was not entitled to refunds of Federal Income and Excess Profits Tax for the calendar years 1934, 1935 and 1936.

### Jurisdiction.

The jurisdiction of this Court is invoked under Sec. 240(a) of the Judicial Code as amended (28 U.S.C.A. §347(a)).

## The Opinions of the Courts Below.

The opinion of the District Court (R. 85-86) is not officially reported. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 95-101) is reported in 151 F. (2d) 954 (1945).

## Statutes and Regulations Involved.

The relevant portions of the Revenue Acts of 1934 and 1936 are Sec. 22 (a) defining "gross income", Sec. 23 (m) providing for the deduction for depletion, and Sec. 114(b)(1) and (3) providing for percentage depletion for oil and gas wells. These sections are identical in the two acts. The relevant portions thereof are set forth in the Appendix at page 24.

The Regulations are Articles 22(a)-5, 23(m)-1(g) and 23(m)-10(a) and (d) of Regulations 86 and 94. These articles are identical in the two Regulations. The relevant portions thereof are set forth in the Appendix at page 26.

## Summary Statement of Matter Involved.

Petitioner is engaged in the production and sale of natural gas. The question relates to the treatment for income tax purposes of "lease bonuses" or "advance royalties" paid in connection with the acquisition of gas leases, to lessors who retained a percentage interest in the current production from the properties.

The questions are (1) whether petitioner-lessee was entitled to treat as part of the cost to it of the gas currently produced the portion of the advance royalties allocable to current production or (2), in the alternative, whether the petitioner was entitled to base its percentage depletion deduction measured by gross income from the property on its

entire share of such gross income without deducting the applicable amounts of advance royalties.

Petitioner contends that the "advance royalties" or "lease bonuses" paid by it to lessors were amounts paid in advance for gas to be produced from a depletable interest in the gas in place reserved by the lessors. As such they would constitute cost of gas purchased by the petitioner-lessee, deductible from gross sales in computing gross income under Article 22(a)-5 of the Regulations (Appendix, p. 26). The Court below denied this claim and held that the advance royalties paid by the lessee were capital expenditures. Such expenditures were considered by the Court to be the purchase price of an immediate depletable interest in the gas in place. The Court held that the current production from this interest was part of the *lessee's* gross income.

In the alternative, petitioner contends that in determining its "gross income from the property" for the computation of percentage depletion under Section 114(b)(3) (Appendix, p. 25), it is not required to exclude the portion of the gross income from current production allocable to the advance royalties if this is held to be its gross income. The Court below also denied this claim, holding that a valid Treasury regulation required the lessee to exclude this portion of its gross income from the property in computing its percentage depletion deduction.

## Questions Presented.

1. Did the Circuit Court of Appeals err in holding that advance royalties paid by a lessee constitute a capital investment by the lessee in a depletable wasting asset and do not constitute the purchase price paid in advance for gas to be produced from the lessor's reserved interest?

2. In the alternative, did the Circuit Court of Appeals err in denying petitioner the percentage depletion deduction on that portion of its gross income from the property allocable to such advance royalties?

## Facts.

All the facts were stipulated in the District Court (R. 25 to 84).

The petitioner during the taxable years was a corporation organized under the laws of Delaware (R. 26).

As lessee of the gas rights under certain oil and gas leases, petitioner during the taxable years 1934, 1935 and 1936, produced and sold natural gas (R. 32-33). All gas produced was immediately sold (R. 35).

Prior to the taxable years on acquisition of the oil and gas leases the petitioner or its predecessor in interest paid to the lessors of such leases, so-called bonuses or advance royalties (R. 29-30). In addition to such advance royalties, the leases provided for the retention by the lessors of a specified percentage, usually ⅛th, of the gas produced from the property and for the payment to the lessors of the proceeds of the sale of this percentage of gas as produced and sold (R. 33).

The petitioner duly filed its corporation income and excess profits tax returns for each of the taxable years with the respondent and duly paid to him the taxes shown to be due thereon (R. 26-27, 31). In its income tax returns for each of the taxable years, the petitioner deducted percentage depletion computed on the basis of the value at the mouth of the well of the gas produced by it less royalties and rentals actually paid out during the taxable years (R. 28).

The Commissioner of Internal Revenue determined that of the total of the advance royalties paid by the petitioner or its predecessor in interest prior to the beginning of the respective taxable years, $20,511 for 1934, $20,309.63 for 1935 and $15,122.80 for 1936 should be considered as allocable to gas actually produced during the taxable years (R. 30).

The Commissioner further determined that for the purposes of the percentage depletion computation, the amounts so determined for each year must be deducted from the amount of proceeds actually received during the taxable years from the sale of gas produced from the leased properties (R. 30). On this basis deficiencies in income and excess profits taxes for each of the taxable years were assessed by the Commissioner. After written protests to the Commissioner were rejected, the petitioner paid the deficiencies determined to be due and duly filed with the Collector claims for refund of such taxes, which were disallowed by the Commissioner (R. 31, 32).

In its complaint in the District Court the petitioner stated four causes of action, the first two containing alternative claims for refund of taxes for the years 1934 and 1935 under the Revenue Act of 1934, while the latter two contained similar alternative claims for refund for the year 1936 under the Revenue Act of 1936 (R. 25). As to each year the petitioner claimed the right to treat properly allocated portions of the advance royalties as *cost of gas* produced from the lessors' reserved interest and purchased by the lessee, or, in the alternative, the right to compute percentage depletion, as it had done in its tax returns, on its full share of the gross income from the property without excluding any amounts representing advance royalties (R. 1-19).

The amounts of refund of taxes to which the petitioner is entitled, in the event either of its alternative contentions

is sustained, have been stipulated by the parties, as follows (R. 36, 37):

TAX REFUNDS CLAIMED BY PETITIONER.

| Calendar Year | If Petitioner is sustained on First Point | If Petitioner is sustained on Alternative Point |
|---|---|---|
| 1934 | $3,845.76 | $1,057.60 |
| 1935 | 2,792.57 | 767.96 |
| 1936 | 2,268.42 | 623.82 |
| Total | $8,906.75 | $2,449.38 |

## The Decisions Below.

The District Court considered that the "applicable authorities" precluded the petitioner's right to recover any of the claimed refunds and therefore dismissed the complaint. The principal authorities relied on were *Quintana Petroleum Co.* v. *Commissioner*, 143 F. (2d) 588 (C. C. A. 5th, 1944) and *Sunray Oil Co.* v. *Commissioner*, 3 T. C. 251, since affirmed 147 F. (2d) 962 (C. C. A. 10th, 1945), cert. den. 65 S. Ct. 1201 (R. 85-86).

The Circuit Court of Appeals held that the portion of the current gross income from the property allocable to advance royalties was gross income of the petitioner-lessee because it was production from a depletable interest in the gas in place which the lessee acquired by payment of the advance royalties. The Court treated the advance royalties as a capital investment by the *lessee* in a depletable economic interest in the gas in place and hence not part of the purchase price of gas bought for resale. This treatment of advance royalties is in direct conflict with decisions of this Court as to the tax effect of the receipt of advance royalties by *lessors*. In *Burnet* v. *Harmel*, 287 U. S. 103 (1932), this Court held that advance royalties were taxable to the *lessor*

as ordinary income and that the *lessor* receiving such payments had made no sale or exchange of property. This Court also held in *Herring* v. *Commissioner*, 293 U. S. 322 (1934), that the *lessor* receiving advance royalties had retained a depletable economic interest in the property which was depleted by production, and was entitled to the depletion deduction with respect to advance royalties. The Circuit Court of Appeals held in the present case that, although the advance royalties were ordinary income to the *lessors* and the *lessors* retained depletable economic interests in the property, the same payments in the same transactions were a capital investment by the *lessee* whereby the *lessee* acquired a depletable economic interest in such property. Petitioner's basic claim is that the Court erred in thus treating the same transaction as giving rise to rights in the lessee which are fundamentally inconsistent with the rights reserved by the lessor.

Petitioner's alternative claim for a percentage depletion deduction on the current gross income allocable to advance royalties was rejected by the Court as contrary to the provisions of Article 23(m)-1(g) of Regulations 86 and 94, requiring the exclusion from gross income of the lessee of appropriate amounts "if royalties in the form of bonus payments or advance royalties have been paid." (Appendix p. 26). This regulation was regarded as applicable and as valid and binding on the petitioner if it elected to take the benefit of percentage depletion, notwithstanding the Court's holding that the advance royalties were a capital investment in a depletable interest as to which depletion based on cost could have been taken.

Judge Learned Hand dissented on the ground that the Court's decision was in conflict with the principles established by the Supreme Court in cases involving the receipt of advance royalties by lessors, and said that the majority

opinion treated the same lease as giving the lessee an immediate interest in the gas for one purpose, and as giving him no interest in it whatever until he actually withdrew it, for another purpose (R. 100).

## Reasons Relied on for Allowance of this Writ.

The Writ of Certiorari should be issued on petitioner's first point because the holding of the Circuit Court of Appeals conflicts in principle with the decision of this Court that advance royalties are paid for units of gas and oil to be extracted from the lessor's reserved interest in the oil and gas in place. *Herring* v. *Commissioner* 293 U. S. 322, 324 (1934). This Court held that advance royalties are taxable to the lessor as ordinary income and not as proceeds from the sale or exchange of property, *Burnet* v. *Harmel*, 287 U. S. 103 (1932), and are depletable by him since he is the owner of the interest which will be exhausted by production, *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 (1934); *Herring* v. *Commissioner*, 293 U. S. 322 (1934). In the very recent decision in *Kirby Petroleum Company* v. *Commissioner* ..... U. S. ..... (January 28, 1946) the Commissioner conceded that the depletion allowance of Sections 23(m) and 114 (b)(3) is applicable to bonuses and current royalties received by a lessor. The opinion of the Circuit Court of Appeals is based on the conflicting view that advance royalties are paid as consideration for an immediate depletable economic interest in the gas in place and not as the purchase price of the gas to be produced from the lessor's reserved interest. The Court erred in concluding that it could properly hold that the *lessee* by paying advance royalties was acquiring an immediate economic depletable interest in the gas in place, when the Supreme Court decisions

conclusively establish that the same transaction was not a disposition by the *lessor* of any such interest. Since the decision below is in direct conflict with the principles established by the Supreme Court, it should be reviewed by this Court.

This point raises an important question of federal law which has been wrongly decided below and has not been passed upon by this Court. The question affects a large majority of the oil and gas leases entered into in this country on a matter of vital importance to those engaged in the oil and gas industry. This question is highly important in the administration of the Internal Revenue Laws and should be settled by this Court.

The Writ should be granted on this point notwithstanding the denial of the Writ on the same question in *Sunray Oil Co.* v. *Commissioner,* 65 S. Ct. 1201 (1945). The dissenting opinion of Judge Learned Hand in the Court below conclusively demonstrates that the opinion of the majority is in direct conflict with decisions of this Court and cannot logically be reconciled with such decisions. In the *Sunray* case, furthermore, the alternative and interdependent claim for a percentage depletion deduction was not involved. The most important point in that case was the wholly unrelated question involving leases of state oil lands.

The Writ should also be issued on petitioner's alternative claim.

This claim is that if the current gross income allocable to advance royalties is petitioner's gross income because produced from an economic depletable interest in the gas in place acquired by it, petitioner is entitled to the depletion deduction with respect to such production, whether computed on the percentage basis or on the alternative cost basis. It was inconsistent for the Court below to hold that

such gross income was produced from the lessee's depletable interest in the property and at the same time to deny the lessee depletion with respect to this share of its gross income. Such denial cannot be justified either on the ground that the amounts which the Court had held to be capital expenditures were "royalties" or on the ground that the Commissioner has power by regulation to deny or limit the percentage depletion deduction allowed by the plain terms of Section 114 (b)(3) of the Revenue Acts of 1934 and 1936. This question also is an important question of federal law which has not been, and should be, decided by this Court because it affects a large number of taxpayers, and is important in the administration of the Internal Revenue Laws.

WHEREFORE, petitioner respectfully prays that a Writ of Certiorari issue under the Seal of this Court to review the decision of the Circuit Court of Appeals for the Second Circuit in the above case.

CANADIAN RIVER GAS COMPANY,
Petitioner.

By ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.

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## BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

### Questions Presented, Statement of Case, Statutes, Etc.

The statement of the questions presented, the statement of the case, and the statutes involved will be found in the petition.

### Specification of Errors and Summary of Argument.

1. The Circuit Court of Appeals erred in holding that advance royalties paid by a lessee constitute a capital investment by the lessee in a depletable wasting asset and do not constitute the purchase price paid in advance for gas to be produced from the lessor's reserved interest. Such decision is directly contrary in principle to decisions of the Supreme Court in cases involving lessors who received such advance royalties.

2. In the alternative, the Circuit Court of Appeals erred in denying petitioner the percentage depletion deduction on that portion of its gross income from the property allocable to such advance royalties. A regulation denying a taxpayer percentage depletion on part of its gross income from the property is contrary to the statute and invalid.

## ARGUMENT.

### I.

**The Circuit Court of Appeals erred in holding that advance royalties paid by a lessee constitute a capital investment by the lessee in a depletable wasting asset and do not constitute the purchase price paid in advance for gas to be produced from the lessor's reserved interest. Such decision is directly contrary in principle to decisions of the Supreme Court in cases involving lessors who received such advance royalties.**

The decision on petitioner's primary contention that the portion of advance royalties allocable to current production represents the cost to the lessee of gas produced from an interest reserved by the lessors in the gas in place, depends on a single basic question. By paying advance royalties to the lessors, was the petitioner-lessee (a) making a capital investment in a depletable wasting asset, as was held by the Court below, or (b) making payment in advance for gas to be extracted from a depletable wasting interest in the gas in place reserved by the lessors?

If the current production allocable to advance royalties was from a depletable interest in the gas in place which the lessee had purchased and owned, such production would, of course, be gross income of the lessee, as was held

below. But if such production was from an interest in the gas in place reserved and owned by the lessors, then the lessee acquired such gas when produced by purchase from the lessors, and the amount paid in advance by the lessee for such gas, namely, the portion of the advance royalty allocable to current production, was cost of goods, deductible by the lessee from gross sales in determining gross income (Article 22(a)-5, Treasury Regulations 86 and 94, Appendix, p. 26).

The decision below turned on this precise point. The current production allocable to advance royalties was held to be gross income of the *lessee* because it was regarded as production from an interest in the gas in place which the lessee had purchased by paying the advance royalties. The Court below refused to recognize that this portion of the production was from an interest in the gas in place reserved by the lessors and that the lessee acquired this share of the gas only by purchasing it from the lessors, the advance royalty being payment by the lessee in advance for gas to be extracted in the future from the lessors' retained interest.

Yet the Supreme Court has determined the status of advance royalties received by the lessor under such a lease. The petitioner "merely asks that the lease shall be construed in the same way, when the lessee is taxed" (R. 100).

As to advance royalties received by the lessor under such a lease, the Supreme Court has held:

> (1) The lessor receiving an advance royalty under an oil and gas lease receives ordinary income and not capital gain from the disposition of any interest in the property (*Burnet* v. *Harmel*, 287 U. S. 103 [1932]).
>
> (2) The advance royalty received by the lessor "is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted", is part

of the lessor's "gross income from the property" and the lessor is entitled to the percentage depletion deduction with respect thereto even though there is no current production in the year the advance royalty is received (*Herring* v. *Commissioner*, 293 U. S. 322, 324 [1934], *Kirby Petroleum Company* v. *Commissioner*, ..... U. S. ..... (January 28, 1946)). The lessor is likewise entitled to depletion based on cost if that is greater than the percentage depletion deduction (Article 23(m)-10, Regulations 86 and 94, Appendix, p. 26). Cf. *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299 (1932).

(3) The depletion deduction allowed the lessor with respect to advance royalties is allowed in anticipation of future production from his retained depletable interest in the property. If there is no future production, and hence no depletion of such retained interest, the lessor must account for the anticipatory deductions so allowed as income in the year the lease is terminated (*Douglas* v. *Commissioner*, 322 U. S. 275 [1944]).

Depletion deductions are, of course, allowable only to those who have an economic interest in the oil and gas in place which is depleted by production (*Palmer* v. *Bender*, 287 U. S. 551 [1933], *Kirby Petroleum Company* v. *Commissioner*, ..... U. S. ..... (January 28, 1946)). Depletion cannot be allowed to anyone who does not have such an economic interest in the property which is depleted by production (*Helvering* v. *Bankline Oil Co.*, 303 U. S. 362 [1938]; *Helvering* v. *O'Donnell*, 303 U. S. 370 [1938]; *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372 [1938]; *Thomas* v. *Perkins*, 301 U. S. 655 [1937]).

As to the lessor receiving advance royalties under an oil and gas lease, it is therefore firmly settled that he has not made a sale of an interest in the property; that the

advance royalties are part of the lessor's gross income from the property and are ordinary income of the same nature as current royalties; that the lessor has reserved the economic depletable interest in the oil and gas in place represented by the advance royalties, and that the lessor is entitled to anticipatory depletion (on either the cost or percentage basis) with respect to such royalties because it is his reserved interest in the oil and gas in place which is wasted or depleted by the production allocable to advance royalties.

The Court below, although conceding in substance that these principles have been established as to the effect of the receipt of advance royalties by the lessor, nevertheless held that these identical payments had a different and wholly inconsistent effect when considered from the standpoint of the lessee.

The Court, in its opinion, said that the advance royalty paid by the lessee "was the consideration paid for an economic interest in the gas bearing land leased" and that the lessee by paying the advance royalty "obtained an asset which was depletable * * * because it was a wasting capital asset which was inherently depletable" and that the advance royalties "were paid as the consideration for the conveyance of a leasehold in which the plaintiff invested to obtain the right to produce gas from the land leased" (R. 99). We submit that this is a decision that the lessee, by paying the advance royalties, acquired a depletable interest in the property which the Supreme Court has held the lessors did not dispose of but retained. There were, of course, various interests in the property. Referring to 1934 production (R. 49), the interest in the gas in place represented by the current royalties of $191,418.37 was retained by the lessors. The interest in the gas in place represented by the gross income of

$817,388.76, determined after deducting current royalties, rents and bonus exhaustion, was a depletable interest acquired by the lessee. But the issue here is, who owned the economic depletable interest in the gas in place which produced the $20,511 of current production allocable to advance royalties? The Supreme Court has held that this interest was reserved by the lessors and that this production depleted the lessors' reserved interest. The Circuit Court of Appeals has erroneously held here that this identical interest was purchased by the lessee and that this production depleted the lessee's interest. This failure of the lower Court to follow the Supreme Court decisions cannot be obscured or glossed over by the loose statement that "after these leases were executed both the lessors and the lessee held depletable economic interests in the property" (R. 98).

The fallacy in the majority opinion below is clearly shown by the following statement (R. 99):

> "It would be plain enough that these payments would have been capital expenditures had they been made for the fee. They were, we think, none the less so because only a leasehold was obtained."

If the petitioner had purchased the fee, the former owner would have made a sale of a capital asset, he would be entitled to no depletion deduction, and he would have no further interest in or relationship to the property. The petitioner would have acquired the entire depletable interest in the property. In cases involving *lessors* this Court has held that the receipt of an advance royalty is essentially different from the receipt of the purchase price for the fee. The Court below, in treating payments for the fee and advance royalties as having the same effect from the standpoint of the *lessee*, simply refuses to follow the Supreme

Court decisions establishing that such transactions are essentially and radically different in nature and consequences.

A particular payment may be income to the recipient and a capital expenditure to the payor, but a transaction which is not a sale by one party cannot be a purchase by the other. A payment which the Supreme Court has held is not the selling price of an interest in the property when received by the lessor cannot be the purchase price of an interest in the property when paid by the lessee. The lessee could not acquire a depletable interest in the property which the lessor kept. And the current production allocable to advance royalties, which the Supreme Court has held was part of the lessor's "gross income from the property" received by him in advance, cannot also be part of the lessee's gross income from the property.

These logical difficulties are not overcome by stating that the advance royalties "were paid as the consideration for the conveyance of a leasehold in which the plaintiff invested to obtain the right to produce gas from the land leased" (R. 99). However the precise rights of the lessee are characterized, the opinion below rests on the premise that in return for the advance royalties the lessee acquired an immediate interest in the gas in place subject to wastage by production. That conclusion cannot be correct, in view of the firmly established principle that the lessors kept and did not dispose of that very interest in the gas in place.

The only conclusion which is consistent with the principles established by the Supreme Court is that the advance royalties were payments "in advance for oil and gas to be extracted" (*Herring* v. *Commissioner*, 293 U. S. 322, 324 [1934]) and were, as the Court below itself said, payments for "the right to obtain a series of transfers of the oil as produced" (R. 98).

As said in the dissenting opinion below,

> "such a 'bonus' is payment in advance for units of gas, in which, although the lessee has the right to withdraw them in the future, the lease gives him no immediate interest. Conversely, the lessor does not part with any interest in the gas until the lessee withdraws it" (R. 100).

The reasoning of the Court in *Sunray Oil Company* v. *Commissioner*, 147 F. (2d) 962 (C. C. A. 10th, 1945), cert. den. 65 S. Ct. 1201, is the same as that of the decision below. That Court also erroneously held as to advance royalties that "with respect to the lessee, they represent cost and are a capital expenditure" (p. 966) and that the portion of the advance royalties allocable to current production "were in no sense the proceeds of oil reserved by the lessors as royalty under the lease" (p. 966).

We submit that the character of the transaction and the rights created by oil and gas leases providing for advance royalties are definitely settled by the Supreme Court decisions in the lessor cases. The petitioner "merely asks that the lease shall be construed in the same way, when the lessee is taxed" and says "that the rights created cannot vary as one looks through different ends of the same document" (R. 100, 101).

We respectfully submit that the decision below should be reviewed by this Court because, in holding that by making payment of advance royalties the lessee acquired from the lessors a depletable interest in the gas in place, the lower Court rendered a decision in direct conflict with the decisions of the Supreme Court that this depletable interest in the property was retained by the lessors. The question involved has not been directly decided by this Court. The question is one of great importance to the oil and gas industry and in the administration of the Internal Revenue Laws. The writ of certiorari on this point should be granted.

## II.

**In the alternative, the Circuit Court of Appeals erred in denying petitioner the percentage depletion deduction on that portion of its gross income from the property allocable to such advance royalties. A regulation denying a taxpayer percentage depletion on part of its gross income from the property is contrary to the statute and invalid.**

Petitioner's alternative argument is that if the amount representing current production allocable to advance royalties is gross income of the petitioner-lessee, as the lower Court has held, it necessarily follows under Section 114(b)(3), Revenue Acts of 1934 and 1936, (Appendix p. 25) that the petitioner is entitled to the percentage depletion deduction with respect to this income.

The Circuit Court of Appeals summarily rejected this contention merely by stating that a valid regulation (Article 23(m)-1, Regulations 86 and 94, Appendix p. 26) denied this deduction (R. 99-100).

The statute, Section 114(b)(3), Revenue Acts of 1934 and 1936, (Appendix p. 25) allows as to oil and gas wells, as an alternative to the ordinary depletion allowance based on cost under Section 23(m),

> "27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

As to any particular taxpayer, the term "gross income from the property" as used in this section means gross income from oil and gas (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 [1934]) of the particular taxpayer whose

depletion deduction is being computed (*Crews* v. *Commissioner*, 89 F. (2d) 412 [C. C. A., 10th, 1937]; *Commissioner* v. *Felix Oil Co.*, 144 F. (2d) 276 [C. C. A., 9th, 1944]; *Commissioner* v. *Crawford*, 148 F. (2d) 776 [C. C. A., 9th, 1945], affirmed ..... U. S. ..... (January 28, 1946). The statutory plan is that each person having an interest in the oil and gas property which is depleted by production should account for his share of the gross income from the property and should be entitled to the depletion deduction with respect thereto (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 [1934], *Kirby Petroleum Company* v. *Commissioner* ..... U. S. ..... (January 28, 1946).

The Court below has held that the current production allocable to advance royalties is gross income of the lessee. This amount is obviously "gross income from the property." Section 114(b)(3) in plain terms allows the lessee the 27½% depletion deduction with respect to this portion of its gross income from the property.

The specific provision of the statute for the exclusion of "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property" has no application because of the holding of the Circuit Court of Appeals that "advance royalties" are not "rents or royalties" but are capital expenditures, the purchase price of an economic interest in the property. Capital expenditures returnable through depletion cannot be "rents or royalties".

The regulation, Article 23(m)-1(g) (Appendix, p. 26) applies only "if *royalties* in the form of bonus payments or advanced royalties * * * have been paid." Literally the regulation is not applicable to lease bonuses or advance royalties which are held to be capital expenditures.

If the regulation is construed as applicable to advance royalties which are capital expenditures it is invalid.

A regulation denying the taxpayer a deduction which the statute clearly allows is invalid (*Trust u/w of Mary Lily Flagler Bingham* v. *Commissioner*, 65 S. Ct. 1232 [1945]; *Koshland* v. *Helvering*, 298 U. S. 441, 446-447 [1936]; *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S. 129, 134 [1936]).

The regulation denying the lessee the percentage depletion deduction with respect to current production allocable to advance royalties was undoubtedly based on the ground that this share of the gross income from the property belonged to the lessor, that the lessor was being allowed the percentage depletion deduction with respect thereto, and that the percentage depletion deductions allowed in the aggregate to all taxpayers having depletable interests in the property should not be more than 27½% of the total gross income from the property (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312 [1934], *Kirby Petroleum Company* v. *Commissioner*, ..... U. S. ..... (January 28, 1946). But the regulation is inapplicable or invalid as applied to current production allocable to a capital expenditure by the lessee for an economic interest in the gas in place.

The statute is perfectly clear. Each taxpayer having an investment in a depletable interest in the property is entitled to the percentage depletion deduction with respect to his share of the gross income from the property, a reasonable and equitable result. The lower Court holds that $20,511 of the 1934 gross income from the property allocable to advance royalties is the lessee's gross income from its depletable interest in the property. The statutory provision for the exclusion of "rents and royalties" is inapplicable. The lessee is therefore entitled to percentage depletion with respect to this share of its gross income from the property by the plain terms of the statute and the Commissioner has no power by regulation to deny a deduction which the statute plainly allows.

In holding that the lessee could claim depletion based upon cost on production from the depletable interest purchased with the advance royalties, but could not claim percentage depletion with respect thereto, the lower Court ignored the fact that every taxpayer who is entitled to a depletion deduction with respect to a depletable interest in an oil or gas property is entitled to compute depletion on the percentage of gross income basis if that produces a greater allowance than that granted by Section 23(m). Cost depletion and percentage depletion are alternative deductions of the same nature allowable to the same person with respect to the same production from the same economic interest. If a taxpayer is entitled to cost depletion with respect to certain production, he is undoubtedly entitled to percentage depletion, if that is greater, with respect to the same production (*Kirby Petroleum Company* v. *Commissioner*, ..... U. S. ..... (January 28, 1946); *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459 [1933]; *Herring* v. *Commissioner*, 293 U. S. 322 [1934]; *Thomas* v. *Perkins*, 301 U. S. 655 [1937]; *Consumers Natural Gas Co.* v. *Commissioner*, 78 F. (2d) 161 [C. C. A., 2d, 1936]; *Champlin* v. *Commissioner*, 78 F. (2d) 905 [C. C. A., 10th]; *F. K. Land Co.* v. *Commissioner*, 90 F. 2(d) 484 [C. C. A., 9th, 1937]; *Commissioner* v. *I. A. O'Shaughnessy, Inc.*, 124 F. (2d) 33 [C. C. A., 10th, 1941]).

On the first point the lower Court holds that by paying advance royalties the lessee acquired an immediate depletable interest in the gas in place. In denying the lessee depletion on the production from this interest, the Court inconsistently treats the lessee as not having acquired this depletable interest. For one purpose this gas is regarded as purchased in place and not as produced, but for the other as purchased upon production from another's depletable interest.

This point high lights the error of the lower Court in holding that the portion of the current gross income from the property allocable to advance royalties was gross income of the lessee. If that erroneous holding is to be adhered to, it is logically impossible to avoid the conclusion that the lessee is entitled under the plain language of Section 114(b)(3) to the percentage depletion deduction with respect to this share of its gross income from the property.

This alternative point is likewise of great importance to the oil and gas industry and in the administration of the Internal Revenue Laws. The question has never been decided by this Court and was not involved in the petition for certiorari in *Sunray Oil Co.* v. *Commissioner*, 65 S. Ct. 1201 (1945). The two questions raised in this petition are interdependent and have been inconsistently decided below. The writ of certiorari on this point should also be granted.

## Conclusion.

For the foregoing reasons it is respectfully submitted that the petition for writ of certiorari to the Circuit Court of Appeals for the Second Circuit should be granted.

Respectfully submitted,

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.

## Appendix.

**Section 22(a), Revenue Acts of 1934 and 1936:**

"Sec. 22. GROSS INCOME.

"(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

**Section 23(m), Revenue Acts of 1934 and 1936:**

"Sec. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * * * * *

"(m) DEPLETION.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between

the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).)"

**Section 114(b), Revenue Acts of 1934 and 1936:**

"Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

"(b) BASIS FOR DEPLETION.—

"(1) GENERAL RULE.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in subsections (2), (3) and (4) of this subsection.

* * * * * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

**Article 22(a)-5 of Regulations 86 and 94:**

"Art. 22(a)-5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see article 23(m)-1(g)."

**Article 23(m)-1(g) of Regulations 86 and 94:**

"Art. 23(m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—

* * * * * *

"(g) * * * In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.' If royalties in the form of bonus payments or advanced royalties (see article 23(m)-10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from 'gross income from the property' for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year."

**Article 23(m)-10 of Regulations 86 and 94:**

"Art. 23(m)-10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) If a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114(b)(1)

or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the lessor's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * *

"(d) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ per cent of the amount thereof; * * *."

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## CITATIONS





684643—46

# In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 819

CANADIAN RIVER GAS COMPANY, PETITIONER

*v.*

JOSEPH T. HIGGINS, FORMERLY UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE THIRD DISTRICT OF NEW YORK

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The opinion of the District Court (R. 85–86) is not reported. The opinion of the Circuit Court of Appeals (R. 95–100) and the dissenting opinion of Judge Learned Hand (R. 100–101) are reported at 151 F. 2d 954.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 9, 1945. (R. 102.)

The petition for a writ of certiorari was filed on February 7, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTIONS PRESENTED

1. Whether the lessee of a gas lease may reduce its taxable gross income by the amount of allocable portions of bonuses which had been paid in prior years to obtain the leases.

2. Whether the lessee, contrary to the explicit requirements of Article 23 (m)–1 (g) of Treasury Regulations 86 and 94, may include in its basis for percentage depletion that portion of the gross income from the sale of gas allocable to the bonuses paid.

## STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra*.

## STATEMENT

The facts in this case were stipulated by the parties (R. 25–84), and were found by the District Court as stipulated (R. 86–87).

The taxpayer is a corporation organized under the laws of Delaware and has its principal office at Colorado Springs, Colorado. For the taxable years in question, 1934–1936, the taxpayer filed its tax returns with, and paid its income and excess-profits taxes to the respondent, who was then the

Collector of Internal Revenue for the Third District of New York. (R. 26–32.)

During the taxable years involved, the taxpayer, as lessee, produced and sold natural gas under various oil and gas leases. (R. 32–33.) With respect to certain of the leases, there had previously been paid by the taxpayer, or its predecessor in interest, certain cash bonuses to the lessors who also retained the right to a specified percentage of production. (R. 33.) The Commissioner determined that the portion of the bonus payments allocable to the gas produced during the taxable years was in the following amounts: 1934—$20,511; 1935—$20,309.63; 1936—$15,122.80. (R. 30, 43.) The Commissioner further determined that there were deficiencies in income and excess-profits taxes which resulted from excessive deductions for depletion because the taxpayer included in its "gross income from the property" (which is the basis for percentage depletion under Section 114 (b) (3) of the Revenue Acts of 1934 and 1936) the above allocable amounts of the bonuses. (R. 26–30, 32.)

After payment of the deficiencies, the taxpayer filed claims for refunds for each of the taxable years. (R. 30–32.) After rejection of the claims, the taxpayer brought suit in the District Court to recover taxes paid in the following amounts, exclusive of interest: 1934—$3,845.76; 1935—$2,792.57; 1936—$2,268.42. The above amounts were

sought to be recovered on the theory that the taxpayer's gross taxable income should not include the allocable portions of the bonuses previously referred to. (R. 11, 16, 36.)

Alternatively, on the theory that it was entitled to a deduction for percentage depletion calculated without excluding any portion of the bonuses, the taxpayer sought recovery of the following amounts, exclusive of interest: 1934—$1,057.60; 1935—$767.96; 1936—$623.82. (R. 13, 18, 37.)

The District Court, after trial, dismissed the complaint. (R. 87.) The Circuit Court of Appeals affirmed the judgment of the District Court. (R. 102.)

## ARGUMENT

1. The court below decided that the taxpayer, in computing its taxable income, was not entitled to any deduction on account of bonus payments previously made to its lessors in connection with the acquisition of certain gas leases. Holding that the bonus payments constituted a capital investment, the court rejected the contention that an aliquot portion of the payments was deductible as part of the cost of goods sold within the meaning of Article 22 (a)–5, Treasury Regulations 86 and 94 (Appendix, *infra*).

The decision below is correct. The proceeds received by the taxpayer from the production and sale of the gas ,which it was not obligated to pay to

anyone else, constituted its gross income under Section 22 (a) of the Revenue Acts of 1934 and 1936 (Appendix, *infra*). If, as we believe, the court below was correct in holding that the bonus payments were capital investments, no portion of those payments could be deducted as constituting the cost of goods sold, it being well settled that gross income includes the entire selling price of the minerals sold. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103; *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376. Since the taxpayer is unable to point to any other provision of the statute or regulations conferring a right to the claimed deduction (cf. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440), the claims for refund were properly rejected. The taxpayer, however, asserts that the court erred in holding that the bonus payments were capital expenditures and contends that its ruling is inconsistent with the decisions of this Court that a bonus payment is taxable as ordinary income to the *lessor* (*Burnet* v. *Harmel*, 287 U. S. 103) and that the *lessor* is to be allowed depletion with respect to the bonus received (*Herring* v. *Commissioner*, 293 U. S. 322). (Pet. Br. 12–18.) As the court below pointed out, however, there is no inconsistency in holding that a payment may represent the cost of a capital acquisition by the payor and still be ordinary income to the payee. (R. 98–99.) Since the bonus payment is "consideration for the lease" (*Burnet* v.

*Harmel, supra,* page 112) which gives rise to valuable rights in the lessee to extract the minerals and retain the proceeds (*Douglas* v. *Commissioner,* 322 U. S. 275, 285–286), it constitutes a capital expenditure by the lessee (*United States* v. *Ludey,* 274 U. S. 295, 302–303).

There is no conflict with the decisions of this Court. Indeed, the issue is one which this Court has already refused to review by certiorari. *Sunray Oil Co.* v. *Commissioner,* 147 F. 2d 962 (C. C. A. 10th), certiorari denied, 325 U. S. 861.

2. The court below also held that, under Article 23 (m)–1 (g), Treasury Regulations 86 and 94 (Appendix, *infra*), the taxpayer was not entitled to percentage depletion on the amounts of the bonuses allocable to the product sold during the taxable years. This result plainly follows under the explicit language of the regulations. The taxpayer, however, contends that the regulations are invalid. (Pet. Br. 20–22.) This contention is clearly untenable. Since the lessor is entitled to percentage depletion on the bonus payments when received (*Herring* v. *Commissioner, supra*), and since the depletion deduction is a single allowance which must, under the statute, be apportioned between the lessor and lessee (*Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312), it necessarily follows that the lessee may not have a deduction for depletion on any part of the bonus with respect to which the deduction was allow-

able to the lessor. The regulations, in providing that the lessee's "gross income from the property" may not include an allocable portion of any bonus payment, are thus designed to carry out the rule that two taxpayers may not secure an allowance with respect to the same item of depletion. Moreover, similar provisions have appeared in all Treasury Regulations beginning with Article 221 (g) Treasury Regulations 77, promulgated under the Revenue Act of 1932, Congress having meanwhile repeatedly reenacted the statutory provision to which it relates. In these circumstances, and in view of the provisions of Section 23 (m) that the allowance is to be made under rules and regulations prescribed by the Commissioner, the regulations are unassailable. *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 309; *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 466; *Quintana Petroleum Co.* v. *Commissioner,* 143 F. 2d 588 (C. C. A. 5th).

The decision below in this respect does not conflict with the holding of the court on the taxpayer's alternative argument. If Congress had intended that there should be an exclusion or deduction from "gross income" under Section 22 (a) for the allocable portion of the bonus which is required by Section 114 (b) (3) (Appendix, *infra*) to be excluded from the depletion basis, it would have so provided.

## CONCLUSION

The decision below is correct and no conflict is presented. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted,

J. HOWARD MCGRATH,
*Solicitor General.*

SEWALL KEY,
*Acting Assistant Attorney General.*

HELEN R. CARLOSS,
HILBERT P. ZARKY,
*Special Assistants to the Attorney General.*

MARCH 1946.

## APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, * * * a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the

gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Sections 22, 23 and 114 of the Revenue Act of 1936, c. 690, 49 Stat. 1648, are identical.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 22 (a)–5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see article 23 (m)–1.

ART. 23 (m)–1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of im-

provements. Section 114 prescribes the basis upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the owner of an interest in mineral deposits, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in section 113, plus, in either case, subsequent allowable capital additions (see articles 23 (m)–15 and 23 (m)–16) with the following exceptions and qualifications:

(1) In the case of coal mines, metal mines, sulphur mines or deposits, and oil and gas wells the aggregate annual allowable deductions may, because of percentage depletion, ultimately exceed the cost or other basis:

* * * * *

(g) The term "gross income from the property" as used in sections 114 (b) (3) and 114 (b) (4) and articles 23 (m)–1 to 23 (m)–28, inclusive, means the following:

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in

the form of bonus payments or advanced royalties (see article 23 (m)–10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

* * * * *

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) If a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the lessor's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * *

(d) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ per cent of the amount thereof; * * *

* * * * *

Substantially similar provisions are embodied in Treasury Regulations 94, promulgated under the Revenue Act of 1936.

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(27)



# Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819

CANADIAN RIVER GAS COMPANY,

*Petitioner,*

*against*

JOSEPH T. HIGGINS, FORMERLY UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE THIRD DISTRICT OF NEW YORK,

*Respondent.*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

## REPLY BRIEF FOR PETITIONER.

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# Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819.

CANADIAN RIVER GAS COMPANY,
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*against*

JOSEPH T. HIGGINS, formerly United States Collector of Internal Revenue for the Third District of New York,
Respondent.

*ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.*

## REPLY BRIEF FOR PETITIONER

**1. Respondent's uniform characterization of the "advance royalties" as "bonuses" does not establish that such amounts are capital expenditures.**

The principal basis for *respondent's* argument is the assumption that the cash payments made to the lessor when the leases were signed were "bonuses" and were not "advance royalties". The whole treatment of the payments by the Commissioner was as advance royalties and that is the status of such payments.

Respondent's brief carefully avoids the use of the term "advance royalties" and, without exception, refers to the payments made by the petitioner to the lessors as

"bonuses." The apparent purpose is to induce the Court to conclude that the payments are capital expenditures merely by calling them "bonuses." The court below first referred to the payments as "advance royalties, or so-called bonuses" and thereafter simply as "advance royalties" (R. 96-99). The stipulation of facts states: "Said items of 'bonus exhaustion' are more accurately designated as recoupment of advance royalties" (R. 29) and that the payments were "so-called bonuses, *i.e.*, cash payments made in connections with the acquisition of such leases" (R. 30). The Treasury Regulations (86 and 94) refer to "bonus or advanced royalty" (Art. 23(m)-10) and make certain provisions "if royalties in the form of bonus payments or advanced royalties* * * have been paid" (Art. 23(m)-1(g), Appendix to Petition, p. 26).

In *Herring* v. *Commissioner*, 293 U. S. 322 (1934), the Court refers to "advance royalty or bonus" (p. 323, 324). In *Douglas* v. *Commissioner*, 322 U. S. 275 (1944), the Court refers to "bonus or advanced royalties" (p. 280). In *Anderson* v. *Helvering*, 310 U. S. 404, 409 (1940), the Court said:

> "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences."

The facts as to the payments in question are undisputed. The parties enter into a gas lease. One provision of the lease is that the lessee must pay current royalties out of current production. Some leases, such as those here involved, also provide for a lump sum payment, which the lessor keeps whether or not there is production. The respondent's contention that this latter portion of the total amount payable by the lessee is a capital expenditure paid

for an economic depletable interest in the gas in place is not supported merely by referring to the payment as a "bonus".

As shown in our main brief, such payments have been held by this Court not to be payments for an interest in the property, but payments of advance royalties for gas to be removed in the future.

**2. Respondent has failed to show how in the same transaction the lessee could acquire a depletable interest in the gas in place which the lessor did not transfer.**

The basic contention of the *petitioner* is that the lump sum payment by the lessee under a royalty lease cannot be a capital investment in a depletable interest in the gas in place because the Supreme Court has held that in such a transaction the lessor does not transfer or part with any such interest. In response to this, respondent merely states the correct general principle "that a payment may represent the cost of a capital acquisition by the payor and still be ordinary income to the payee" (p. 7). That statement wholly fails to meet the point, as is conclusively demonstrated in the dissenting opinion below (R. 101). Respondent makes no effort to show how it is possible *in the same transaction* for one party to acquire an interest which the other party does not transfer. Nor does he make any effort to identify the property interest representing the alleged "capital investment."

The complete statement in *Burnet* v. *Harmel*, 287 U. S. 103, 112 (1932), of which respondent quotes a phrase, is:

> "Bonus and royalties are both consideration for the lease and are income of the lessor. We cannot say that such payments by the lessee to the lessor,

> to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production."

This is the decision which holds that the lessor receiving advance royalties makes no sale of an interest in the property. Yet the Court is asked to refuse to review a holding that *in the same transaction and for the same payment* the lessee acquired from the lessor a depletable economic interest in the gas in place.

Of course, the lease as a whole and the payment of the current royalties and advance royalties required thereunder gave the lessee the "right to extract" gas from the property (*cf. Douglas* v. *Commissioner*, 322 U. S. 275). But that does not mean that either the advance royalties or the current royalties were a capital investment in the gas in place. Any such holding as to either type of royalties is impossible in view of the fact that the lessors are entitled to the depletion deduction (whether computed on the cost basis or the percentage basis) with respect to both current royalties and advance royalties, because the production attributable to these depletes the lessor's reserved interests in the gas in place.

If respondent fails in his contention that advance royalties are a capital investment by the lessee in the gas in place, the whole basis for the decision below collapses. If the lessee has not purchased the interest in the gas in place represented by advance royalties, such payment by the lessee must be, as the Supreme Court has said, "payment in advance for oil and gas to be extracted" (*Herring* v. *Commissioner*, 293 U. S. 322, 324 [1934]). The payment,

therefore, is part of the lessee's cost of gas produced from the lessor's reserved interest, which must be deducted from gross sales to determine the lessee's gain and gross income (Regulations, Art. 22(a)-5, Appendix to Petition, p. 26). No deduction from gross income is involved and no deduction for depletion is involved.

**3. Respondent's contention that an allocable portion of the bonus must be excluded from the depletion base as "royalties" is irreconcilable with his contention that advance royalties are capital expenditures by the lessee.**

On petitioner's alternative contention that it is entitled to a larger depletion deduction if the production allocable to advance royalties is production from a depletable interest in the gas in place which it has purchased, the respondent contends that Section 114(b)(3) requires the exclusion from the depletion basis of an "allocable portion of the bonus" (p. 7). This contention is that such amounts are "rents or royalties paid or incurred by the taxpayer in respect of the property." There is a direct and inherent conflict in holding that advance royalties are a capital investment in the gas in place for the purpose of treating as petitioner's gross income the production from this interest in the property and in the next breath holding that such payments are "royalties" under Section 114(b)(3). These two holdings are irreconcilable.

Petitioner's alternative contention does involve the allowance of percentage depletion both to the lessor and to the lessee with respect to the same gross income from the property. This results, however, only because respondent insists on treating these amounts as gross income of the

lessee as well as gross income of the lessor. If the same gross income from the gas property is to be taxed to different taxpayers, then, under the plain terms of the statute, both should be allowed depletion with respect thereto. But, if the depletion deduction cannot be allowed to both, the lessee's right to the deduction would seem to be superior to that of the lessor, if the lessee is to be treated as having purchased from the lessor the economic interest in the gas in place from which such production came.

Respectfully submitted,

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.

# Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819

CANADIAN RIVER GAS COMPANY,
*Petitioner,*

*against*

JOSEPH T. HIGGINS, formerly United States Collector of Internal Revenue for the Third District of New York,
*Respondent.*

*ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.*

## MOTION FOR LEAVE TO FILE OUT OF TIME PETITION FOR REHEARING OF PETITION FOR WRIT OF CERTIORARI.

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
*Counsel for Petitioner.*

Pandick Press, Inc., 22 Thames St., New York 6, N. Y., U. S. A.

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*ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.*

## MOTION FOR LEAVE TO FILE OUT OF TIME PETITION FOR REHEARING OF PETITION FOR WRIT OF CERTIORARI.

*To The Honorable The Chief Justice of The United States and The Associate Justices of The Supreme Court of The United States:*

The above-named petitioner, by its counsel, Arthur A. Ballantine and George E. Cleary, respectfully moves for leave to file at this time with your Honorable Court the annexed petition for rehearing of the petition for certiorari which was denied on March 25, 1946 (66 S. Ct. 818).

The ground for this unusual motion is that the decision of the Court below, review of which is sought, is in clear conflict with the decision of this Court handed down April

22, 1946, in *Burton-Sutton Oil Company, Incorporated, Petitioner,* v. *Commissioner of Internal Revenue,* October Term, 1945, No. 361. Since this decision was rendered after the expiration of the 25-day period within which a petition for rehearing could be filed as a matter of right, this motion for leave to file the petition for rehearing is necessary.

## Jurisdiction.

The discretionary jurisdiction of this Court to grant leave to file such petition for rehearing is invoked under Rule XXXIII of this Court, notwithstanding the fact that more than twenty-five days have elapsed since the denial of said petition. The Court has previously exercised such jurisdiction (*Douglas* v. *Willcuts,* 293 U. S. 626, 295 U. S. 722, 296 U. S. 1). Under Rule XXXIII the Court has the power, vested in both trial and appellate courts, to reconsider its own decisions within the same Term (*Bronson* v. *Schulten,* 104 U. S. 410, 415; *United States* v. *Benz,* 282 U. S. 304, 306, 307; *Wayne Gas Co.* v. *Owens Co.,* 300 U. S. 131, 136; *Hazel-Atlas Co.* v. *Hartford-Empire Co.,* 322 U. S. 238, 244). This case originated in the District Court and not in the Tax Court, so that it is not governed by *R. Simpson & Co.* v. *Commissioner,* 321 U. S. 225. There is no statute comparable to Section 1140, Internal Revenue Code, which was the basis of that decision, applicable to decisions of the District Court.

Respectfully submitted,

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Canadian River Gas Company, Petitioner.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945.

No. 819.

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CANADIAN RIVER GAS COMPANY,
Petitioner,

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JOSEPH T. HIGGINS, formerly United States Collector of Internal Revenue for the Third District of New York,
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*ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.*

## PETITION FOR REHEARING OF PETITION FOR WRIT OF CERTIORARI.

*To The Honorable The Chief Justice of The United States and The Associate Justices of The Supreme Court of The United States:*

Comes now the petitioner in the above-entitled cause and presents this its petition for a rehearing of its petition for certiorari, and in support thereof respectfully shows:

### I.

Rehearing should be granted because the decision of the Court below, which was the basis for the petition for certiorari, is in clear conflict with the decision of this Court in *Burton-Sutton Oil Company, Incorporated, Petitioner,* v. *Commissioner of Internal Revenue,* October Term, 1945,

No. 361, decided April 22, 1946, since the denial of the petition for certiorari.

## II.

What is presented in this case is the federal income tax status of advance royalties paid by lessees of oil or gas leases. In its suit in the District Court, from which appeal was taken to the Circuit Court of Appeals, the taxpayer maintained that advance royalties becoming applicable to aliquot portions of current production are deductible by the operating lessee from current receipts. The petitioner also contended in the alternative that if the proper amounts of such advance royalties are not to be treated as payments against current production, and hence deductible by it, the lessee is entitled to percentage depletion in respect of the production thus treated as part of its gross income from the property. The decision below was adverse to petitioner on both points. The respondent and the petitioner were in agreement on the facts in this case.

In making its principal argument, petitioner relied upon decisions of this Court that advance royalties such as are here involved are not payments for an interest in the oil or gas property but are payments for the right to remove oil or gas. These decisions were rendered in cases relating to the taxes of lessors, not of lessees, and clearly held that such payments are not to be treated by the lessors as payments received for an interest in the property but instead as payments in advance for oil or gas to be removed.

*Burnet* v. *Harmel*, 287 U. S. 103;
*Herring* v. *Commissioner*, 293 U. S. 322;
*Kirby Petroleum Company* v. *Commissioner*, 66 S. Ct. 409 (January 28, 1946);
*Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312;
*Douglas* v. *Commissioner*, 322 U. S. 275.

The Circuit Court of Appeals rejected this argument as follows:

> "The fallacy of that argument lies in the assumption that since the advance royalties are taxed to the lessor as ordinary income because they are part of the consideration passing to the lessor for granting to the lessee the right to obtain a series of transfers of the oil as produced, *Burnet* v. *Harmel, supra,* the grant in the hands of the lessee is not to be treated as a capital asset nor the advance royalties paid for it as a capital investment. * * *
>
> "What the lessor gets *for* the lease and how that should be taxed does not control decision as to the character of what the lessee gets *under* the lease. Just as advance royalties may be consideration for a lease and also ordinary income to the lessor, *Burnet* v. *Harmel, supra,* they may be capital investments by a lessee when paid for capital assets. * * * So it does not follow, as the plaintiff argues, that because the advance royalties are taxable as ordinary income to the lessors the lessee did not make a capital investment when it paid them in consideration for the leases." (R. 98-99)

Petitioner maintained that the decision of the Court below was inconsistent with the decisions of this Court above referred to. However, that decision was in harmony with decisions of two other Circuit Courts of Appeal, and petitioner was then unable to cite a decision of this Court which dealt with the question in the case of a lessee.

The decision in the *Burton-Sutton Oil Company* case is a decision as to the status of royalty payments made by an operating lessee and squarely supports the argument of the petitioner.

In the *Burton-Sutton Oil Company* case the Court dealt with the right of an operating company to deduct from its

gross receipts an amount substantially equivalent to 50% of the net proceeds of oil produced and sold from property which the operating company was required to pay under a contract to the Gulf Refining Company. The Court said:

> "A decision on the category of expenditures to which these 50% disbursements belong affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other."

The Court thus holds that such a payment cannot be a capital investment to the operating company where it is ordinary income and not a capital sale to the recipient. The position taken by this Court was the position taken by Judge Learned Hand in his dissent below, where he said:

> "The plaintiff merely asks that the lease shall be construed in the same way when the lessee is taxed. It says that if a 'bonus' is 'advance royalties' and a payment for units to be later withdrawn, which remained the lessor's while they are *in situ*, it must be 'advance royalties' when the opposite party, the lessee, is taxed: that the rights cannot vary as one looks through different ends of the same document." (R. 100)

The only difference in the facts involved in the *Burton-Sutton Oil Company* case and the facts involved in this case is that the royalties paid by the lessee in the *Burton-Sutton Oil Company* case were current royalties, whereas in the case below the royalties involved were advance royalties paid at the time of the execution of the lease, but there is no distinction in tax status between advance royalties and current royalties.

As stated in the *Burton-Sutton* decision,

> "It is not material whether the payment to the assignor is in oil or in cash which is the proceeds of the oil, *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 321, nor that some of the payments were in the form of a bonus for the contract. *Burnet* v. *Harmel,* 287 U. S. 103, 111; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 302."

In *Anderson* v. *Helvering,* 310 U. S. 404, 409, this Court said:

> "The holder of a royalty interest—that is, a right to receive a specified percentage of all oil and gas produced during the term of the lease—is deemed to have 'an economic interest' in the oil in place which is depleted by severance. * * * Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences."

In the same case the Court said (p. 407):

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas in taxable and to whom a deduction for depletion is allowable. The issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest."

In *Douglas* v. *Commissioner,* 322 U. S. 275, 280, the Court said:

> "Royalty or bonus payments in advance of actual extraction of minerals are, like sales after severance or royalty payments on actual production, gross income and not a recovery of capital."

It is therefore apparent that the decision below is wholly in conflict not only with the principle of the earlier deci-

sions of this Court in the lessor cases, relied upon by petitioner in its petition for certiorari, but also with the decision of this Court in the lessee case handed down after the petition was denied.

On this ground certiorari should be granted.

Certiorari should also be granted on petitioner's alternative point as the two questions are interdependent and have been inconsistently decided below as shown in the petition for certiorari.

Wherefore, petitioner respectfully petitions for a rehearing of the petition for a writ of certiorari and respectfully prays that a writ of certiorari issue under the seal of this Court to review the decision of the Circuit Court of Appeals for the Second Circuit in the above case.

Respectfully submitted,

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Canadian River Gas Company, Petitioner.

## Certificate of Counsel.

We, ARTHUR A. BALLANTINE and GEORGE E. CLEARY, counsel for the above-named petitioner, do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for delay.

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.